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Competition in the Australian Financial System
Productivity Commission
GPO Box 1428
Canberra ACT 2601

Dear Commissioners

Competition in the Australian Financial System

The Bank of Queensland (**BOQ**) welcomes the opportunity to respond to the issues set out in the Terms of Reference for the Productivity Commission's Inquiry into Competition in the Australian Financial System (**Inquiry**).

We firmly believe regional banks play a vital role in Australia's banking industry and have been part of the fabric of the community for more than 100 years. However, as a result of ongoing regulatory change, market dynamics and prudential settings, the industry has evolved to the competitive detriment of the regional banks. This has provided a significant structural advantage to the major banks to maintain and grow market share.

BOQ believes the Productivity Commission should seek to redress these structural imbalances and restore competitive neutrality to the banking industry so that Australia consumers can access the best products and services at the most competitive price.

BOQ, Bendigo & Adelaide Bank, ME Bank, Suncorp and AMP Bank have made a joint submission to this Inquiry. The joint submission provides detailed background information and provides greater context around the competitive challenges of regional banks and the public policy issues that need to be addressed to restore competitive neutrality.

BOQ will not repeat issues already raised in the joint submission. The purpose of this submission is to provide BOQ's perspective on the regulatory and prudential settings impeding effective competition between the major and regional banks and put forward our recommendations to correct it.

Background to BOQ

BOQ was established in 1874 as the Brisbane Permanent Benefit Building and Investment Society. In 1887 it converted into a bank but did not become a trading bank until 1942. In 1970 it officially became the Bank of Queensland and was listed on the ASX in 1971.

Throughout the 1970s and 1980s the Bank continued to grow, and in 1985 it began to open regional branches.

BOQ prides itself on its commitment to customer service, delivered through a range of channels including its unique Owner-Managed branch (**OMB**) model. It offers a full range of simple, easy to understand banking products and services to individuals and businesses.

Over the past 15 years, BOQ has undergone considerable expansion, both organically and through the acquisition of various businesses including Virgin Money Australia and BOQ Specialist.

BOQ now has lending assets of $43 billion. Its OMBs are owned and managed by people who live locally, know their customers well and are willing to go the extra mile to ensure customers receive exceptional personal service. This relationship based approach extends across BOQ's entire business, including Retail and Online Banking, Business Banking, Agribusiness and Financial Markets, Equipment, Debtor & Vendor Finance and Insurance.

BOQ currently operates 190 branches across Australia and provides fee-free access for its customers at more than 3000 ATMs nationally.

BOQ has also expanded its Business Banking presence by moving into the niche business segments of agribusiness, health & retirement living, corporate healthcare and hospitality & tourism. BOQ has topped the East & Partners business banking customer satisfaction survey for the past eight years and has been named Relationship Bank of the Year at the Asia-Pacific Banking and Finance Corporate and Business Banking Awards for the past four years.

Enhancing competition and resilience in the Australian banking industry

Australian banks play a critical role in the effective operation of Australia's economy. The Australian banking system has the highest reliance on offshore funding of material banking jurisdictions across the globe[1]. As a consequence, it is critical that Australia's banks, particularly those that have the highest dependence on offshore markets, are seen as resilient and "unquestionably strong".

Australia has one of the most concentrated banking sectors in the world. Authorised deposit-taking institutions (**ADIs**) write 91% of all domestic residential mortgages – of this, internal ratings-based banks (being the four major banks and Macquarie) represent 84% of the loans with standardised banks (of which BOQ is one) representing the balance 16%. This level of concentration creates risks to the stability and degree of competition in the Australian banking system.

A competitive banking sector is a key driver of the industry's resilience and efficiency. However, Australian banks are not competing on a level playing field and this is hampering effective competition.

The uncompetitive advantage of the Australian major banks

The major banks enjoy two main competitive advantages over the regional banks: (1) reduced funding costs; and (2) lower regulatory risk weights on credit exposures.

1. **Reduced funding costs**
   The major banks benefit from reduced funding costs. Although larger and more diversified institutions should naturally attract lower funding costs, a significant factor driving the differential is the benefit major banks receive through higher credit ratings as a result of implicit government support[2]. This is directly evidenced by the explicit 3 notches of Government support embedded in Standard & Poor's AA- ratings of the major banks. Absent this notching uplift, the stand-alone credit profile[3] of the major banks is 'a-', which is one notch above BOQ's stand-alone credit profile of 'bbb+'.

   In May 2017, Standard & Poor's (**S&P**) downgraded the ratings of 23 banks, including BOQ, but left the four major banks and Macquarie's ratings unchanged. In outlining this position, S&P explained that they believe that these banks will receive timely financial support from the

[1] Reserve Bank of Australia, Financial Stability Review, September 2012, Table A2

[2] See Joy C, 'Australian Financial Review, Budget 2017: Big four still benefit from generous taxpayer subsidy, making levy fair', 11 May 2017; Morrison MP, Media Release – 'Building an accountable and competitive banking system', 9 May 2017; House of Representatives Standing Committee on Economics, Review of the Four Major Banks: First Report, November 2016

[3] The stand-alone credit profile is S&P's opinion on a bank's credit worthiness in the absence of Government support.

Australian Government if needed which offsets the deterioration in the banks' stand-alone credit profiles[4]. Importantly, although S&P decreased the major banks' stand-alone credit profile from 'a' to 'a-', they simultaneously increased the notches of Government support from 2 notches to 3 notches which offset the stand–alone credit profile downgrade. The net result was that the major banks rating was unchanged at AA- whilst BOQ was downgraded to BBB+. Table 1 below outlines the rating agency's credit rating assessments across the major banks and key regional banks.

Table 1 – Major and regional bank credit ratings, S&P and Moody's

	Major Banks		Macquarie Bank		Suncorp		BEN, BOQ		AMP Bank		Newcastle Perm		ME Bank		Heritage
	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	Moody's
Anchor	**bbb+**		**bbb+**		bbb+		bbb+		bbb+		bbb+		bbb+		
Capital	-		1		1		1		2		2		2		
Bus. Pos	1		-						-2		-2		-2		
Risk Posn	-		-1												
Funding /Liquidity	-		-		-1		-1		-1		-1		-1		
SACP / BCA	**a-**	**a2**	**bbb+**	**baa1**	**bbb+**	**baa1**	**bbb+**	**baa1**	**bbb**	**baa3**	**bbb**	**a3**	**bbb**	**baa1**	**baa1**
Parent Support	-	-	-	-	3	2			3	4					
Adj. BCA		**a2**		**baa1**		**a2**		**baa1**		**a2**		**a3**		**baa1**	**baa1**
Sovereign Support	3	2	2	2		1		1							
ALAC / LGF	-	-	-	-											
ICR	**AA-**	**Aa3**	**A**	**A2**	**A+**	**A1**	**BBB+**	**A3**	**A**	**A2**	**BBB**	**A3**	**BBB**	**Baa1**	**Baa1**

Source: Rating agencies and Westpac

The four major banks and Macquarie obtain a direct funding cost benefit as a result of this uplift because market participants take it into account when valuing bank debt[5].

The recently introduced Major Bank Levy (**Levy**) could be characterised as akin to an insurance premium paid by the four major banks and Macquarie for their implicit government guarantee. The Levy does, in some part, address the funding benefit the four major banks and Macquarie receive. We estimate the major banks' benefit to be 15-20 basis points, consistent with the Reserve Bank of Australia's own study[6], which is roughly three times the amount of the 6 basis points Levy.

2. Lower regulatory risk weights on credit exposures

Australia's capital framework for ADIs includes two approaches for determining risk weights for the purposes of calculating capital ratios:

a. the **standardised** approach[7], where a common set of risk weights seek to reflect the general risks of different broad asset classes. BOQ adopts this approach.
b. the **internal ratings- based** approach (**IRB**)[8], where accredited ADIs use their own internal models to determine risk weights for credit exposures. This is also referred to as an 'advanced´ approach. The four major banks and Macquarie are accredited under this model.

The Financial System Inquiry (**FSI**) examined these approaches at length and made two significant findings[9]:

a. The gap between average IRB and standardised mortgage risk weights means IRB banks can use a much smaller portion of equity funding for mortgages than standardised banks and this translates into a significant return on equity advantage.
b. The relative riskiness of mortgages between IRB and standardised banks does not justify one type of institution being required to hold twice as much capital for mortgages than another.

The FSI recommended that the average IRB mortgage risk weight should be raised to narrow the differences between average risk weights of IRB banks and standardised banks[10]. This

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[4] S&P Global Ratings, Ratings on 23 Australian Financial Institutions Lowered on Build-up of Economic Imbalances, release date 22 May 2017
[5] Schich S and Lindh S, OECD Journal: Financial Market Trends, Volume 2012 –Issue 1 – Implicit Guarantees for Bank Debt: Where do we stand? page 5
[6] Reserve Bank of Australia, Parliamentary Briefing – Implicit Guarantees for Banks, 24 February 2012
[7] APRA Prudential Standard APS 112 – Capital Adequacy: Standardised Approach to Credit Risk
[8] APRA Prudential Standard APS 113 – Capital Adequacy: Internal Ratings-based Approach to Credit Risk
[9] Financial System Inquiry Final Report, November 2015 page 61

recommendation sought to “improve the competitive neutrality of capital regulation by limiting distortions caused by the differential regulatory treatment of different classes of ADI”[11].

In response to this recommendation, in July 2015 the Australian Prudential Regulation Authority (**APRA**) announced it was increasing the average residential mortgage risk weight for IRB banks from 16% to 25%. This increase took effect in July 2016.

While this increase was a positive step forward, it was not enough to neutralise the competitive advantage enjoyed by IRB banks and level the playing field.

Standardised banks are currently subject to an average mortgage risk weight and BOQ’s average mortgage risk weight is 43%. As a result, IRB banks receive a significant capital advantage – currently, if an IRB bank holds $2 of capital against a home loan a standardised bank would be required to hold around $3.50 against the same loan. In respect of certain low risk assets, this differential is considerably larger and would result in a much bigger difference in capital holdings – the joint submission quotes one example of an IRB bank calculating a risk weight on residential mortgages of between 0% and 2.5%[12].

BOQ and other standardised banks simply cannot compete on a level playing field until this gap is further reduced.

Table 2 is a simplified example of a mortgage portfolio that shows the estimated portfolio returns between IRB and standardised banks based on the differential funding cost and risk weighting benefits of an IRB bank.

Table 2 – Estimated mortgage portfolio returns, IRB versus standardised banks

	Major Bank	**Regional Bank**
Lending Rate[13]	4.15%	4.15%
Funding Rate	2.35%[14]	2.50%[15]
Margin	**1.80%**	**1.65%**
Operating Expenses[16]	-0.60%	-0.60%
Loan Impairment Costs[17]	-0.05%	-0.05%
Pre Tax Return on Assets	1.15%	1.00%
Return on Assets	**0.81%**	**0.70%**
Risk Weighting[18]	**25%**	**40%**
Return on Risk Weighted Assets	3.2%	1.8%
Common Equity Tier 1 ratio[19]	10.50%	8.50%
Return on Equity	**22%**	**14%**

Source: Bank of Queensland

[10] Financial System Inquiry Final Report, November 2015 recommendations 2 page 60
[11] Ibid
[12] Joint regional bank submission, ‘Levelling the playing field in retail banking’, page 60
[13] Lending Rate based on average industry home loan rates (RBA F5 August 2017 Lending rates; Housing loans; Banks; 3-year fixed; Owner-occupier)
[14] Major Bank Funding Rate is based upon Regional Funding Rate less TBTF Funding benefit assumed at 15 basis points
[15] Regional Funding Rate based on average industry Term Deposit rates (RBA F4 August 2017 Retail deposit and investment rates; Banks' term deposits ($10000); 3 years)
[16] Operating Expenses assumed at 60 basis points
[17] Loan impairment expense assumed at 5 basis points.
[18] Risk weighting assumed at 40% for Regional Banks and 25% for Major Banks
[19] Common Equity Tier 1 ratio based upon APRA's higher "unquestionably strong" requirements. The 2% higher ratio for the Major Banks is based upon the 1% higher unquestionably strong requirement and the 1% DSIB buffer. Tax rate for the purposes of calculation is assumed at 30%.

Impending changes to the prudential regulatory framework

The Basel Committee on Banking Supervision (**BCBS**) is currently reviewing the global bank regulatory framework, with particular focus on capital requirements to support credit risk.

The Global Financial Crisis (**GFC**) demonstrated a failure in IRB models to accurately reflect the risks of mortgage-related and other securities. The underestimation of risk was a major contributor to the issues that emerged.

The opaque nature of these models meant they were ineffective in providing external stakeholders, such as funding market participants, with any confidence in the internal risk weighting models employed by these banks. In the post GFC reviews, the BCBS has raised concerns with inconsistencies identified in the IRB models across multiple jurisdictions[20] particularly in relation to IRB banks[21]. This was a key component of the lack of confidence that created the liquidity crisis.

In response, the BCBS is revisiting the existing credit risk requirements for both standardised[22] and IRB banks[23]. A new standardised framework is being developed which is expected to enhance the granularity of risk categorization and provide more comparability with the IRB approach with respect to treatment of similar exposures. For the IRB banks, a capital floor is being introduced to banks' internal models, calibrated to the new standardised framework.

The latest direction from the BCBS is that the capital floor will be implemented on a total risk weighted assets level. We believe that greater industry resilience and improved competition would be achieved by applying in the IRB approach a floor to each individual standardised risk weighted asset categories. This approach would provide greater transparency for each portfolio risk and support continual external stakeholder confidence in the IRB models, which is particularly important in a crisis scenario.

Recommendation for enhancing competition and resilience

APRA has jurisdictional discretion to implement the principles of the BCBS framework with variation that reflects the specific characteristics of the Australian banking system. APRA therefore has the opportunity to address the current competitive imbalances in the way it implements the BCBS framework.

BOQ strongly recommends that APRA require the application of an individual floor for IRB banks to each individual standardised risk weighted asset category. Individual floors will create a more transparent and resilient banking system and improve stakeholder understanding of risk across product categories.

Without individual floors for each category of risk weighted asset, the IRB banks can select the portfolio exposures they wish to participate in that demonstrate a higher positive deviation from the standardised requirement. This approach would make standardised banks uncompetitive in certain customer/product segments where IRB banks can offset a lower risk weighting against portfolios with a higher risk weighting.

BOQ also recommends that APRA require all ADIs to report risk weightings on an internationally harmonised standardised basis, where APRA defines the deviations it has made from the base BCBS approach. This will enhance credibility with internationally harmonised risk weighting data which is critically important in an industry with such over-reliance on offshore markets.

Currently, most ADIs report internationally harmonised capital ratios but the harmonisation adjustments are self-assessed. This creates inconsistencies between data sets and makes it difficult for investors to compare and understand the risk profiles within different banks and

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[20] Bank for International Settlements, Basal Committee on Banking Supervision, 'Reducing excessive variability in banks' regulatory capital ratios – a report to the G20', November 2014

[21] Basal Committee on Banking Supervision, Regulatory Consistency Assessment Program (RCAP), Analysis of risk-weighted assets for credit risk in the banking book

[22] Basal Committee on Banking Supervision, Consultative Document, Standards – Revisions to the Standardised approach for credit risk was issued for comment by 27 March 2015

[23] Basal Committee on Banking Supervision, Consultative Document – Reducing variation in credit risk-weighted assets: constraints on the use of internal model approaches was issued for comment by 24 June 2016

segments. This approach also lacks the transparency necessary for an efficient and reliable banking system.

We welcome the opportunity to discuss these matters with you further and look forward to being involved in the Inquiry as it progresses over the coming 12 months.

Yours sincerely

Jon Sutton
Managing Director and Chief Executive Officer